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Three financial phenomena were key to the economic boom: unrestrained debt creation, soaring stock prices, and abundant international liquidity. In all cases the party is ending, and the hangover is just beginning. Credit problems were not even on most investors' minds a few months ago… Yet the surfacing financial difficulties are part of a growing, economy-wide syndrome that will in time lead to financial sector crises, dramatic tightening of lending standards, and serious interference with economic activity.

The Levy Institute Forecast
November 2000

PROFITS MELTDOWN

Simple logic and wishful thinking have it that the worst of the U.S. economy's downturn, thanks to a highly flexible Mr. Greenspan and a spendthrift consumer, is already over. Just as America led the world on the way down, goes the argument, its imminent recovery will lead the world back up again to a new growth path. Scrutinizing the hard facts that count crucially for economic growth, we observe something in the United States that excludes any possibility of economic recovery. Instead, it is the definite harbinger of much worse to come. That something is a profit carnage of unprecedented vehemence.

Apart from disclosing the trumpeted profit miracle of the past years as sheer bogus, this traumatic profit disaster raises questions about its underlying cause or causes. Are they just cyclical or structural and secular? We have always warned this would happen and make our familiar, critical case in this respect. It has an obvious reason: Poor profitability in large parts of Corporate America over the past few years was obscured by deceptive propaganda and large windfall gains in the booming stock market.

Though shocking the markets with some rather negative remarks about the economy's short-term prospects, in a recent testimony on monetary policy to Congress, Fed Chairman Alan Greenspan expressed unflinching optimism about the outlook in the long run that seems to have started in the current quarter. According to him, the Fed's panel of forecasters all expect economic growth in the 1.25-2% range for all of 2001 and in the 3-3.25% range for next year.

In this letter, we also contradict the widespread view that the consumer might keep the U.S. economy out of recession and in due time revive capital spending. It is another great fallacy in popular thinking. Capital spending is collapsing despite more resilient consumer spending. Rather, negative wealth and income effects are progressively eroding the consumer's resilience. The obvious decisive factor behind the U.S. economy's sharp downturn is collapsing corporate earnings, for which no end is in sight.

Monetary policy works with considerable time lags. So much faith has been invested in the skill and wisdom of Mr. Greenspan that the failure of his six aggressive rate cuts to show any effects so far seems to cause little or no worry. That may be appropriate with reference to effects on the real economy. But this complacency is definitely misplaced as regards the absence of any positive effects in and on the financial markets — stocks, bonds and currency. In fact, the responses of these markets are the true channels through which monetary easing essentially stimulates consumer and business spending. The implicit, necessary market reactions — higher bond and stock prices, and a lower currency — have always occurred promptly in the past. For the first time ever in the whole postwar period, the monetary easing, though extremely aggressive, proves a complete fiasco in the financial markets.

While Mr. Greenspan has massively eased, the markets have in reality tightened. It ought to be understood that this inherently aborts the economic recovery that everybody sees. Of course, it may be argued that stock prices would be much lower still without the Fed's rate cuts. Yes, but this implies that the situation is even worse than it seems. In any case, there is very little ammunition left to fight further deterioration in the economy and the markets with new rate cuts.

NOT JUST INVENTORIES

According to media reports, the prospects for a U.S. economic recovery took center stage at the latest meeting of finance ministers of the Group of Seven industrialized countries in Rome. Center stage in this letter is an analysis of the current disastrous income and profit trends in the U.S. economy, spelling dramatically worsening conditions both for businesses and the consumer. Several statistics, such as data from the National Association of Purchasing Managers (NAPM) and surveys of consumer confidence, suggest some improvement in the economy, yet the objective economic data point overwhelmingly downward. The all-important consideration for us is that Corporate America is being ravaged by its worst profit carnage in the whole postwar period.

Over just two quarters, from Q3 2000 to Q1 2001, overall profits in the nonfinancial sector have plunged 17.5%. Manufacturing profits are down 60% from their level in the third quarter of 2000. Nasdaq recently reported that composite earnings for the companies listed on that stock exchange were negative. Available data and foreseeable economic and financial influences suggest that the slide in profits is sure to keep worsening. The question is not what will trigger a recession, but what might be able to stop the snowballing of the recessionary processes already under way.

It's the eighth month now since Mr. Greenspan started his dramatic interest rate cuts. It is true that monetary policy always needs time to take effect. Yet, allowing for the extraordinary size and speed of the rate cuts, there ought to be the first signs of a beginning recovery, if not in the economy proper then in the economic data or in the financial markets. Actually, the public is bombarded with reassuring remarks and grossly biased bits of information in the obvious intent to preserve confidence in the prompt effectiveness of the actions taken by the Fed and the government.

What is the evidence they offer for their cheerful forecasts? None, none at all. There is not even the slightest attempt of a reasoned substantiation. As is readily admitted, the one and only thing that these recovery forecasts are built on is faith, blind faith, *first of all*, in the skill and omnipotence of Mr. Greenspan; and *second*, in the flexibility and resilience of the U.S. "new paradigm" economy.

Remember: Thanks to the wonders of the new information technology, both the business cycle and inflation were consigned to the history books, and productivity and profits would grow forever at miraculous rates. All of a sudden now, the reality is America's worst economic downturn in the whole postwar period, and what's more, its biggest contributor is the very sector that was to be the economy's pillar of stability — the new information technology.

Amazingly, the public discussion about the economy's downturn remains narrowly focused on the inventory overhang. The mythmakers insist that the economic weakness stems from a too-tight monetary policy and the inventory correction that it triggered. All that is required to fix the economy again are rate cuts and a boost to money growth. In actual fact, the economic decline began in the face of rampant money and credit growth; and as to the inventory overhang, its correction has hardly begun.

The most worrisome legacies of the bubble years are in reality the unsustainable escalation of consumer spending, as reflected in record debt ratios and negative personal savings, and in the extremely unbalanced pattern of capital spending. Many millions of private households struggle to meet record debt service payments from shrinking real income growth, and millions are starting to face up to vanishing financial wealth. In the past few months, booming mortgage refinancing has largely offset these massive negative effects on the consumer's finances. But this, too, is rapidly falling off.

OPTIMISM TALKED, NOT PRACTICED

Stunningly, belief in the U.S. economy's "new paradigm" qualities seems to be unshaken up till now. Still, we hasten to add that this pronounced optimism and bullishness in the markets is far more talked than practiced. Measured by the poor U.S. stock market performance since the beginning of the year, bullish action by way of effectively buying shares remains elusive. Any net new inflows into stock mutual funds compare miserably with purchases in the past. In the discussion about a possible new bull market, in our view there is far too much talk about money growth in general and far too little attention to the miserable balance sheets of private households and corporations.

To realize the U.S. economy's dismal longer-term prospects, as we have repeatedly stressed, requires precise knowledge of the nature and pattern of the present downturn. Of what kind and of what size are the structural distortions and maladjustments that have accumulated during the boom? That's the key question to be asked and investigated.

We stress the word "structural." For the great majority of today's economists, credit excesses have but one possible malign effect, and that is a significant rise in the inflation rate. Its absence is supposed to permit unlimited credit expansion. The effective, perverse result of this simplistic perception is that low inflation rates have tended to foster the greatest credit excesses in history. It did so in the 1920s in America, in the late 1980s in Japan, and so again in the late 1990s in America.

The structural distortions arise from the fact that the credit excesses do not spread evenly across the whole economy. They always concentrate on certain areas — real estate, business investment in plants and equipment, consumer durables — and accordingly they fuel specific bubbles of demand. In other words, they distort the economy's demand structure. There is no fixed pattern for this. During the 1920s, the bulk of the credit excesses in the United States went into private consumption. In the case of Japan's bubble, they poured overwhelmingly into commercial building, plants and equipment. In the present U.S. case, it is again private consumption and the high-tech sector.

But that's only the initial part of the maladjustment process impacting the economy. The resulting distortions in the composition of demand implicitly evoke corresponding dislocations in the economy's output and investment structure. In order to meet the credit-driven surge in demand, those sectors in the economy that largely attract the inflated demand for their products tend to step up their investment spending, which the economy's later slowdown will expose as malinvestments.

A QUEER INVESTMENT BOOM

Until recently, the U.S. economy's record-high rate of capital spending was widely hailed as the key force behind the trumpeted productivity and profit miracle and the shift to a "new paradigm" economy. According to the national income and product data, private non-residential investment during the 1990s climbed as a share of GDP from barely 10% to almost 14%. The bulk of that increase came from business spending on IT equipment and software, showing a rise in its share of GDP from 7% to 10%. During the boom years 1995-1999, the *direct* contribution of high-tech products — such as computers, software and telecommunications — to real GDP growth averaged 24%, or 0.9 percentage points of the 3.8% growth of GDP.

We have always expressed strong reservations about America's alleged extraordinary investment boom. First of all, it is grossly at variance with the record-low national savings that have to make the necessary resources available. In fact, the U.S. investment boom of the late 1990s accrued not from savings but from two changes in the U.S. GDP statistics. The so-called hedonic price-indexing of high-tech was one, and the decision to treat software as capital investment, rather than as a business expense, was the other.

The numbers give some food for thought. Business spending on IT equipment, without software, increased from $192.2 billion to $302.6 billion in current dollars between 1996 and 2000. This $110.4 billion increase accounted for 5.1% of nominal GDP growth during this period. Normally, nobody would call this an investment boom. But thanks to treating this investment spending with hedonic price indexing and further by capitalizing

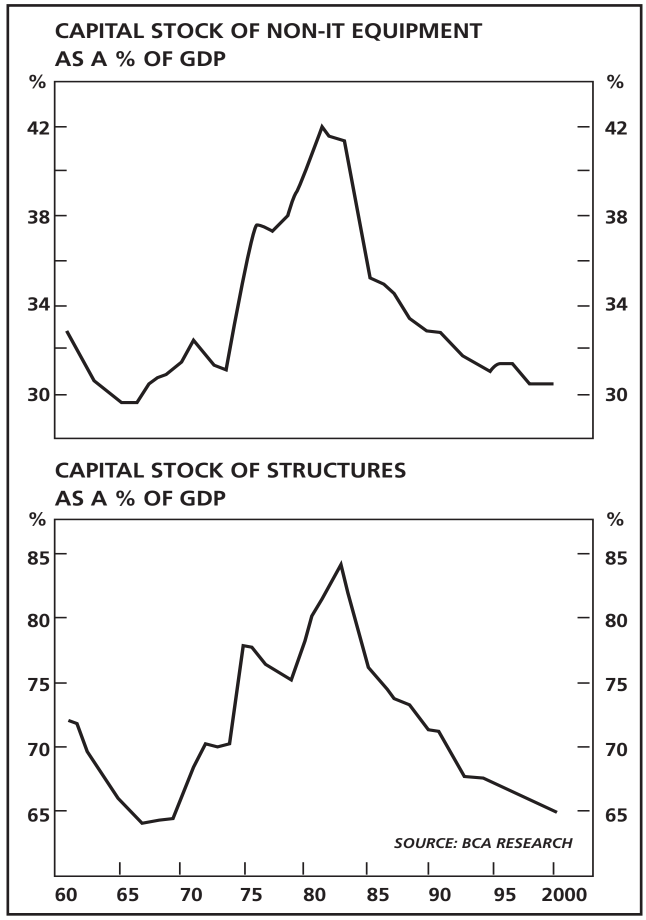
software spending, this amount exploded in the GDP accounts, measured in chained dollars, into a majestic increase of $389.3 billion, which contributed 25.8% of real GDP growth. A pleasant side effect was America's reported productivity miracle.

Yet, even measured in current dollars, the spending on the new information technology certainly qualifies as an investment boom. Above all, it contrasts conspicuously with the anemic rate of capital spending on industrial equipment, representing the machinery of the goods-producing Old Economy. During the same period it increased by a mere $32.1 billion, from $136.4 billion to $168.5 billion. For each dollar that Corporate America invested in production facilities, it has invested almost three dollars in information.

ANOTHER IMBALANCE

As the last letter pointed out, America's problem in the investment sphere is not overinvestment across the whole economy but a grossly imbalanced investment structure.

Due to a massive shift in new investment towards short-lived assets, particularly of the high-tech kind, the strong pickup in the investment ratio during the past few years largely reflects rapidly rising corporate depreciation charges. Subtracting investment that merely replaces aging capital stock leaves a modest level of net investment. The distinguishing features of the Old Economy's manufacturing sector have been outsourcing and hollowing out, leaving spending on structures and non-IT equipment far below earlier peaks. Since the mid-1980s both components of the capital stock, representing about 90% of the total, have never stopped to decline as a share of GDP. The falling level of net investment relative to GDP implicitly reflects unusually high consumer spending and the corresponding slide in the personal saving rate.



SPOTTING THE MIRACLE

Still, there is no denying that the technology sector has been the main source of growth for the U.S. economy during the 1990s. Yet saying this, we have to distinguish between effects on and in the economy and effects on and in the financial markets.

It is our long-held view that, from a strictly economic perspective, computers, Internet and telecommunications are minor-league technologies that do not measure up to technological breakthroughs in the past, such as electricity, automobiles, the internal-combustion engine or the railroad. These profoundly changed the world, and there is a second difference that we regard — from the macro perspective — of utmost importance for profit and wealth creation: Those technologies involved massive capital formation in tangible, productive assets that gave birth to prosperous capital goods industries — in contrast to massive dissaving and paper wealth creation today.

Today's new information technology, too, has imparted tremendous wealth and income effects. However, there is an all-important difference between them and the industrial technologies. This time, these effects have not come from producing and using this technology. They have overwhelmingly accrued from the fantastic financial effects that the tech companies have been generating mainly through astronomic capital gains in the stock market and the issuance of stock options. These financial effects were the true and the only miracles that occurred, and they occurred because millions and millions of investors were systematically deceived into the

perception of an unfolding productivity and profit miracle due to the new technology.

The proof of the miracle seemed to be strikingly visible in the splendid reported U.S. GDP growth numbers. In reality, it has been manifest for years that the splendor of these numbers owed entirely to those two innovations in the statistical measurement of business spending on new high-tech equipment mentioned earlier: hedonic price-indexing and capitalization of software.

Let there be no doubt, what we have witnessed in the U.S. financial markets since 1995 is history's greatest financial bubble. An increase in nominal GDP by $2,800 billion was accompanied by a credit expansion of more than $10,000 trillion. Indescribable credit excesses, exploding consumer and corporate debts, monstrous use of leverage upon leverage, collapsing personal saving, an exploding current-account deficit — together they all describe an economy that has accumulated economic and financial imbalances of unprecedented scale.

The massive diversion of credit into the financial markets and of spending into imports created, in the same vein, the mirage of a low inflation rate. It is an open secret that a substantial part of stock market gains served to bolster otherwise poor business profits. Yet the bulk of these capital gains, several trillions of dollars, went into consumer wealth. Without question, this crucially inspired the inordinate consumer-spending boom that developed during these years.

According to the Fed's Flow of Funds Accounts, the market value of corporate equities and mutual fund shares owned by private households has more than trebled between 1994 and 2000 Q1, from $4.1 trillion to $12.7 trillion. This does not include pension fund reserves that almost doubled from $4.9 trillion to $9.2 trillion. Total liabilities, on the other hand, increased "only" from $4.7 trillion to about $7 trillion. The net result, in the view of the bulls, is a consumer balance sheet of excellent shape that will allow him to keep up his spending. This, essentially, assumes no further major losses on stock holdings. The fact is that within just one year consumer finances have dramatically deteriorated. By the first quarter of 2001, indebtedness was up another $596 billion to $7.3 trillion, while the market value of his stock holdings is down $4 trillion to $8.7 trillion.

THE WORST-EVER PROFIT CARNAGE

It used to be established wisdom among economists that the specific excesses of the boom determine both the specific pattern and the severity of the following downturn. Its causes reside in distorted demand and output structures and, most importantly, in overextended balance sheets both of businesses and private households. As long as the economy booms, it seems to cause no problem. But once incomes and profits are hit by a slowing economy, balance sheet troubles surface and escalate.

The apparent primary propellant of this U.S. economic downturn is business capital spending. While high-tech hardware is suffering the steepest slide, the retrenchment is taking place across all sectors, except for structures and housing so far. But what has prompted this sudden, dramatic downdraft in capital spending? Literally every postwar recession has arisen from tight money and credit. Observing, however, incessant records in credit expansion in general and in the issuance of corporate bonds in particular, this cause appears out of place this time. The extraordinary tightness that is propelling this downturn has developed somewhere else: in business profits.

Every recession squeezes profits. But the profit squeeze, ravaging the U.S. economy since the third quarter of last year, is most unusual in its ferocity. The decline that has occurred within just two quarters already vastly exceeds that in the recession of 1991, and by all accounts, the results of the quarter just ended are sure to be considerably worse. From quarter to quarter, nonfinancial pre-tax profits were down $52.3 billion in the fourth quarter of 2000 and another $51 billion in the first quarter of 2001. Hardest hit is manufacturing. Its pre-tax profits over the three quarters since 2Q '00 have plummeted from $201.8 billion to $131.4 billion in 1Q '01.

A comparison with the profit performance during the 1991 recession may put these numbers into shocking perspective. At the time, overall nonfinancial corporate pre-tax profits barely budged to $222.1 billion, down from $223.8 billion the prior year. The main loser was manufacturing, with a pronounced decline in profits from $112

billion to $92.7 billion, whereas profits in the retail sector continued to soar from $20.6 billion to $26.1 billion.

Another comparison, characterizing the worst structural dislocation in the U.S. economy, is the following: Since 1990, the pre-tax profits of the retail sector have more than quadrupled from $20.6 billion to recently $91.8 billion at annual rate. Manufacturing profits during the same period, on the other hand, have made it from $112.3 billion to merely $131.4 billion.

This extreme divergence in the profit performance between manufacturing and retailing during the 1990s strikingly highlights the horrendous imbalance that has developed in the U.S. economy between producing and consuming.

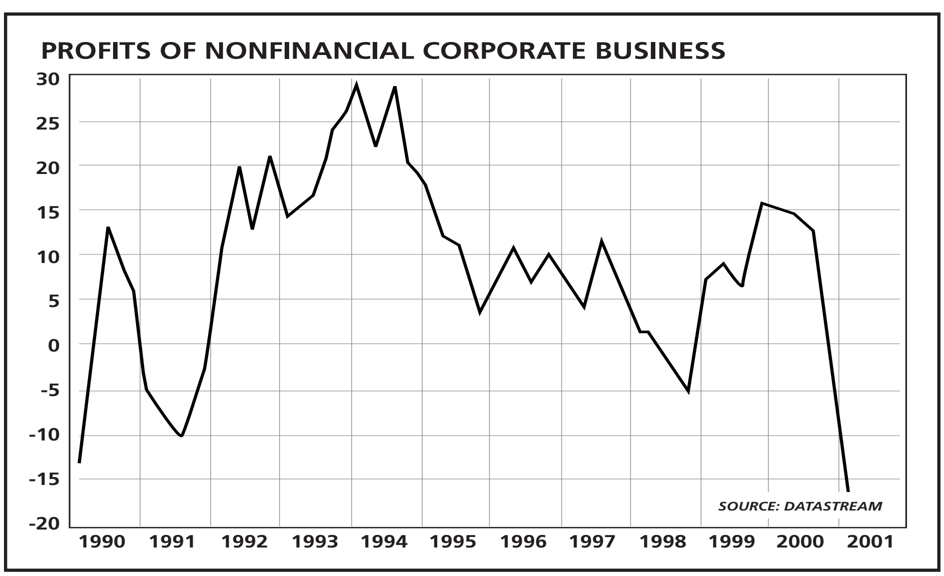
After all, it becomes a compelling conclusion that this extraordinary blood bath in corporate profits is the single most important and truly decisive, primary cause of the U.S. economy's sudden slide. In view of the sustained overabundance of credit expansion, it is the only reasonable explanation. The profit carnage has hammered corporate capital spending. But its effect doesn't stop there. As capital spending falls, the inherent investment multiplier essentially decreases the growth of consumer incomes.

IT IS STRUCTURAL

Recognizing the extraordinary profit carnage and its important role in fueling the U.S. economy's downturn is one thing. But what is causing it? Is it just cyclical? Or could it be structural and secular? Of all questions posing themselves at this juncture, the one about the cause or causes of the U.S. economy's downturn is unquestionably of the greatest importance.

Everyone has been trumpeting that a productivity miracle was creating a profit miracle. Regarding the asserted productivity miracle largely as statistical bogus, we kept a critical eye on the profit numbers. But in contrast to the bullish consensus who focused on the profits reported by the corporations, we fixated on the numbers from the official national income and product accounts (NIPA) that were flatly contradicting the assertion of a profit miracle. True, for the decade as a whole profit growth compares positively with GDP growth. But there is a snag in this comparison concerning the timing of the profit growth. Almost two-thirds of it occurred in the decade's first half, when annual real GDP growth averaged barely 2%. Little more than one-third of the overall profit growth during the 1990s occurred in the second half, which ranks as the period of the great productivity and profit miracle. The chief cause of the sharp rise in profits during the first half, by the way, was plunging corporate interest expenses.

Back to the all-important question: Is the profit carnage unfolding in the U.S. economy just cyclical or perhaps structural and secular? After careful considerations, we don't doubt the latter — this profit malaise is structural and secular. For us, the most striking and most visible evidence for this contention is in the following chart that we have presented before. The most important thing that it reveals is that the poor profit performance really started in 1994. Right through the great boom, profit growth barely kept pace with nominal GDP growth.



Regarding profits — rather than share prices — as the lifeblood of the capitalist economy, we have addressed this problem many times before. It begins with the question of

how Wall Street could possibly spend years celebrating a profit miracle that the official NIPA data flatly negated.

In short, analysts simply ignored the unexciting data from this macro source and concentrated on the earnings per share that the firms reported. NIPA profits over the 1990s have roughly doubled. S&P earnings, in contrast, have tripled.

PROFITS FRAUD

Lately, complaints are increasingly advanced in the media that American companies are using loads of gimmicks to bolster their reported profits and fool investors. It is readily admitted that this already happened during the great bull market in order to deliver the permanent rise in sales and earnings that Wall Street wants to see. But the new complaints say that these ploys to mislead unwary investors are becoming more and more aggressive and reckless. It does not astonish us.

One obvious reason for this trend is the dramatic deterioration in the profit performance. To keep investors nevertheless in good spirits essentially requires all the more cheating. Quoting *Business Week: "Fading dot-coms, new tech giants, and venerable blue chips all hype their earnings.*" *Webster's* describes hype as swindle, deception, or trick.

An obvious second reason is that the most expedient source of dressing up reported profits — the former big, easy gains in the stock market — has dried up. Intel recently reported a net fall of its earnings by 94% from $3.14 billion to a mere $196 million. The year-earlier earnings, however, had included a $2.1 billion gain from realized profits in the stock market. How does this bear on future profits? What will Intel earn in the long run without stock market gains?

Considering that the rise in S&P earnings increasingly outpaced the rise in NIPA earnings, Wall Street's preference for this profit measure is self-evident. It gave a more favorable but definitely not a more reasonable picture. The lion's share of the divergence between the two measures arises from the contrasting treatment of two items — capital gains and stock options. As to capital gains, NIPA calculations ignore them; S&P calculations include them. As to option-generated personal income, they are reported to the IRS as employee expenses and calculated in NIPA as profits. But in the reported profits that go into the S&P numbers, option-generated income is not treated as an expense, to the benefit of profits.

Both components run into huge amounts. Official estimates put corporate capital gains for 1997 and 1998 at around $200 billion each year. They would have bolstered NIPA profits by about 25%. According to published calculations, reported profits of many blue chip corporations would be 30-50% lower if option-generated incomes were treated as an employee expense. Taken together, the sums involved through capital gains and stock options are certainly big enough to make all the difference between the S&P profit miracle and NIPA profit malaise.

Like everything else, the profit fraud went to unprecedented excess. The main task of today's American manager is no longer efficient production but efficient ballyhoo that boosts the company's share price. The systematic deception was plain to very many people, but nobody wanted to spoil the profitable game. Integrity and reason went out the window. In reality, it was much more than just that. It was systematic fraud.

Back to the chart about U.S. profits in the 1990s on page 6. To repeat, the fact that the profits malaise started seven years ago, in 1994, strongly suggests its structural nature, particularly in consideration of the fact that it happened against the backdrop of the U.S. economy's most rampant boom during the whole postwar period. What's more, even NIPA profits are considerably flattered by another statistical change in recent years. It was the government statisticians' decision to count the exploding software outlays no longer as corporate expense but as investment.

TWO KEY PROFIT DEPRESSANTS

In earlier letters, the last one in particular, we have explained in some detail that there are two major profit killers of structural nature at work in the U.S. economy. After seriously hurting its profit performance during the

boom, they are now hitting the profit performance of the slowing economy with a vengeance. The two major profit killers are a lack of net investment and the monstrous trade deficit.

To repeat some key points in brief: The one big, structural profit depressant is Corporate America's preference for acquisitions and mergers at the expense of net investments. For us, those great buzzwords of the shareholder value universe, such as downsizing and restructuring, are euphoric synonyms for corporate strategies to avoid investment in new plants and equipment. Together with acquisitions and mergers, they are, from a macro perspective, condemned to utter failure in generating higher profits for the economy as a whole. Chasing fast profits in this way, Corporate America undermines its long-term profits. The main source of macro profits, and consequently of aggregate micro profits, is investment spending in excess of depreciation charges — that is, net investments. And they are badly lagging in America.

The other big, structural profit depressant in the U.S. economy is the phenomenal trade deficit. The decisive consideration in its case is that most of the money flooding into imports comes from the wage bill of Corporate America. But instead of returning through the purchase of domestic goods as revenue, the money flows abroad, becoming the revenue of foreign producers.

Looking again at the profit chart on page 6, a sharp recovery in 1999 strikes the eye. Its manifest chief source was the steep drop in personal saving. Applying macro logic again, the important point about this kind of consumer spending is that — in contrast to spending of money from wages — it is business revenue that has involved no business expenses. Still, its profit effect was considerably mooted because a large part of that spending was diverted into soaring imports, that is, to foreign producers.

Meanwhile, in 2001, the consumer has continued to run amok against his savings. Yet in this respect there is an important difference in comparison with the past: *first*, personal savings are now deep in negative territory; and *second*, the present borrowing binge no longer finances higher spending but offsets the vanishing growth of his real disposable income.

With their drop in the first quarter, profits have now declined in two consecutive quarters and recorded their first year-over-year drop since 1998. But the current decline is incomparably sharper. Declining fixed investment, further cuts in inventories and a reversal in personal saving are likely to be the major negative influences on profits in the foreseeable future.

EUPHORIA ON HOLD

After Mr. Greenspan's semi-annual Report on Monetary Policy on July 18 to Congress, something completely unprecedented happened. The U.S. stock market responded with a distinct decline. Reading his speech, we had the impression that it contained quite a few positive remarks:

"Despite the recent economic slowdown, the past decade has been extraordinary for the American economy… While the litany of risks should not be downplayed, it is notable how well the economy has withstood the many negative forces weighing on it… More recently, incoming data on economic activity have turned from persistently negative to more mixed… We need… to be aware that our front-loaded policy actions this year coupled with the tax cuts under way should be increasingly affecting economic activity as the year progresses… As for the years beyond this horizon, there is still, in my judgment, ample evidence that we are experiencing only a pause in the investment in a broad set of innovations that has elevated the underlying growth in productivity to a rate significantly above that of the last two decades preceding 1995."

All in all, he expressed unflinching belief in the wonders of the New Economy in the long run, but he didn't hide his short-term doubts.

Yet he disappointed his audience in the markets with several remarks that were apparently more pessimistic than had been expected from him. Being used to getting nothing from him but rampant euphoria, it was shocking to hear this time instead:

"But the uncertainties surrounding the current economic situation are considerable, and… the risk would

seem to remain mostly tilted toward weakness in the economy… Pressures on profit margins have been unrelenting. Although earnings weakness has been most pronounced for high-tech firms, where the previous extraordinary pace of expansion left oversupply in its wake, weakness is evident virtually across the board… Despite evidence that expected long-term rates of return on the newer technologies remain high, growth of investment in equipment and software has turned decidedly negative… In addition, a deterioration in sales, profitability, and cash flow has exacerbated the weakness in capital spending."

CONSUMER TO THE RESCUE?

We come to the great hero in the drama of America's economic downturn: the consumer.

In our view, though, he deserves rather more pity than admiration because his confidence in Mr. Greenspan and the U.S. economy's future is grossly misplaced. For sure, confidence is a very important requisite for economic growth. But we should better distinguish between ill-judged confidence and confidence that is fully justified by the objective conditions prevailing in an economy. We have always had great sympathy for historians who have counted *excess of confidence built up in the previous boom* among the main causes of the following crisis. If you think it over, you wonder whether it is not the most important cause of all. Mr. Greenspan was outstanding as a central banker in delivering not only unprecedented money and credit excesses but also in stoking the unprecedented collective manic euphoria that is indispensable to fuel the frantic spending of that money.

Most reports that we read about the American consumer contend that, despite many adversities, he remains in sufficiently good shape to financially keep America and the global economy from tumbling into recession. We can only express our utter amazement about this view that is widely shared inside and outside of America. The ability and willingness of individuals to increase their spending depend partly on changes in their wealth and partly on changes in their incomes. Both were strongly positive for the American consumer in the boom years. Last year and in the course of the current year, however, both of them have turned dramatically negative.

It finds little attention. Concerns about record-high debt ratios of private households are discarded with the blithe argument that they have been vastly outpaced by much bigger wealth gains in the stock market. The idea that another few more trillions of dollars of this accumulated paper wealth might be taken away via further stock losses is too far-fetched for them to take into lasting consideration.

Pondering the breakneck financial behavior of the American consumer, two questions pose themselves: first, is his apparently endless borrowing and spending binge sustainable; and second, what is making him so reckless?

Let's first have a look at the facts.

CHANGES IN CONSUMER INCOMES AND EXPENDITURES (IN BILLION CHAINED DOLLARS)

	1999	2000	2000 first half	2000 second half	2001 Q1	2001 April-May
Real disposable income	230.6*	143.0*	89.9	53.3	37.0	5.4
Consumer expenditures	323.6	272.3	159.6	112.7	45.5	26.8
Personal saving	147.6	-8.5	15.0	-33.5	-64.4	-80.0
Consumer debt	532.4	566.2	287.2	298.1	139.9	
Stock holdings**	532.4	566.2	287.2	298.1	139.9	

** measured from fourth quarter to fourth quarter ** value in trillion dollars*

Source: Survey of Current Business, Commerce Department

Looking at these numbers, it is beyond our comprehension how anybody can seriously expect the financially ravaged American consumer to sustain economic growth. It is disaster wherever one looks: in rapidly shrinking income growth, in soaring indebtedness, in heavily negative savings and in the vanishing wealth. They spell a

compulsory consumer-spending bust for the near future.

Personal consumption is normally driven by income growth. But when a "bubble economy" develops, wealth effects overwhelm the income effects, as reflected in a plunging personal saving rate. The stellar debt numbers suggest that the consumer, instead of selling equities to finance his higher spending, used them and his house as collateral to take on more debts. The implicit implication: He remains fully exposed to falling stock prices. Admittedly, it is amazing that he continued his borrowing binge, notwithstanding huge losses on his stock holdings. For the bullish consensus this is reason enough to conclude that this can continue indefinitely.

We think it's the blueprint for financial disaster. It shows a savage financial squeeze hitting the consumer from all sides: through the meltdown of his stock holdings, rapidly shrinking income growth, soaring indebtedness and heavily negative savings. Real disposable income growth has, effectively, collapsed in the last few months. Following a sharp rise in the course of 1999 by $230 billion, it fell in 2000 to $143.1 billion with a sharp break between the first and second half. After recovering in the first quarter of 2001, in April-May it slumped close to zero. For those two months, a miserable $5.4 billion added to real incomes compared with $25.8 billion added to spending.

We read hopeful comments that the drop in gas prices and the imminent tax rebates will considerably bolster the consumer's purchasing power. For sure, they will help him. But it is a race, and in our view a hopeless race, of these benefits against much bigger current and future income losses accruing from the corporate sector's savage cutting of costs and capital outlays, apparently gaining in intensity. Every dollar less spent is a dollar less for other people's available income.

To us, those figures about the consumer's finances suggest above all an unbelievable financial recklessness, for which there is but one explanation: high-riding expectations in conjunction with unbridled overconfidence in policymakers. Obviously, the American consumer is simply betting on the economy's V-shaped recovery that everybody predicts. And to be sure, he has a lot of company in this respect. Not only that, another very important factor in this respect is certainly the almost religious faith in America in the power of central banks in general and of Mr. Greenspan in particular to prevent any recession.

DETERIORATING FURTHER

We come to the two most important questions of all: First, what are the signs of the U.S. economy's widely anticipated second-half pickup; and second, what are the chances that the monetary easing will reinvigorate the sluggish economy?

Of the two questions, the first one is the easiest to answer. Leaving aside opinion polls, there is absolutely nothing in the available economic data that confirms an imminent pickup of the economy. Rather, the endless stream of disastrous profit warnings and announcements rather signal relentless further deterioration.

As to the second question, we must admit to have been prejudiced by the view that the bubble-related imbalances and dislocations in the U.S. economy are much too big to be rapidly purged by monetary easing. For the time being, we see nothing but strong confirmation of this presumption. In his testimony before the Senate Banking Committee, Mr. Greenspan expressed his conviction that the *"monetary easing in the pipeline"* will have its desired effects on the economy. For us, the fact that his dramatic rate cuts lack any positive response even by the financial markets is compelling proof of their total lack of effectiveness. If such drastic cuts fail to help the financial markets, how can they help the economy?

This is without precedent in the whole postwar period. In the autumn of 1998, for example, three small rate cuts taking the federal funds rate from 5.5% to 4.75% had immediate, big effects in the financial markets: the yield of 10-year Treasuries fell three-quarters of a percentage point; the dollar dropped steeply against the yen and euro, and U.S. stock prices surged about 20%.

How to explain this strange and ominous behavior of the U.S. financial markets and also the dollar essentially blunting the Fed's actions? As to long-term interest rates, they have apparently drifted up on growing fears about inflationary stresses. And the strong dollar is generally ascribed to a widespread conviction that,

however bad U.S. economic prospects may be, they are sure to be better than the outlook for Europe and Japan.

If you think this over, you come to the paradox conclusion that the thorough failure of monetary easing in the United States may have its main cause in the fact that the upbeat messages of policymakers and Wall Street about the U.S. economy's present and future strength have been rather too successful in persuading U.S. and global investors that the economy's sluggishness is a non-event. If so, this optimism has, however, not helped the stock market.

EURO AND DOLLAR

The central focus of our attention in the global financial markets is not the Dow or the Nasdaq. It is the euro-dollar exchange rate. It is by far the single most important price in the global financial universe involving many trillions of dollars. Consider that foreign gross holdings of dollars amount to almost $10 trillion, as against American holdings of foreign assets amounting to approximately $8 trillion. The United States is a net debtor by about $2 trillion to the rest of the world, of which more than half has accrued during the last three years. For the first trillion, it took about 15 years.

Formerly, the movements of exchange rates were primarily influenced by changes in the trade balances. Weakness in the current account used to mean a weak currency. But in the 1980s, ballooning capital flows became the more powerful market force. Despite a rapidly rising trade deficit, in the first half of the decade the dollar was riding high on the back of soaring capital inflows. This was an utterly new experience for the currency markets.

The great surprise that shocked markets and policymakers occurred in late 1984–early 1985 when the dollar inexplicably accelerated its surge against the backdrop of slowing economic growth and falling interest rates in the United States. In late January and early February 1985, the United States joined in concerted interventions against the dollar. Yet the market boosted it further from DM 3.17 to DM 3.47 in late February.

We have done this little excursion into history in order to show that the present experience is by no means unique. Still, it's most important to see, on the other hand, that some big differences exist between then and today.

It begins with the tremendous difference between the German Bundesbank and the European Central Bank. The Bundesbank never permitted the slightest doubt that it regarded the D-Marks' weakness as both undesirable and unjustified, and it had no qualms whatsoever to demonstrate its opinion with unilateral interventions. Nevertheless, its determination and credibility didn't stop the superdollar. As to the European Central Bank and its president, Mr. Wim Duisenberg, we find it impossible to say one single positive word about them. Perhaps the dollar was unstoppable, but Mr. Duisenberg, in particular, has rightly earned the contempt of the markets with repeated careless remarks, among them his complete disinterest in the euro's weakness. Quite fitting to this is his apparent inability to grasp the dangers in the world economic situation.

Having said this, we hasten to follow up with the question: What about Mr. Greenspan and Mr. Paul O'Neill, the U.S. treasury secretary. In contrast to Mr. Duisenberg, they exercise enormous influence in the market. But we regard this as evil and extremely negative. A mere comparison between Mr. Greenspan with former Fed Chairman Paul Volcker may elucidate what we mean by this remark. Mr. Volcker pursued his monetary policy with the focus on money and credit as the primary targets of his policies. Mr. Greenspan, on the other hand, has distinguished himself as the most prominent cheerleader of the American "new paradigm" economy, importantly contributing to the collective, manic euphoria that developed and grossly imbalanced the U.S. economy. Certainly, Mr. Greenspan is far more dangerous than Mr. Duisenberg.

We come to another difference between 1985 and 2001 that we regard as the most important one. It concerns the relative weight of manufacturing interests versus Wall Street interests in American policy decisions. In 1985, with Jim Baker at the helm of the U.S. Treasury, the Reagan government, worrying about the damage that the overvalued dollar was doing to the manufacturing sector, took the initiative for concerted G5 action against the strong dollar. The result was the Plaza Agreement of Sept. 22, 1985. Its secret provisions featured up to six weeks of intervention to initially knock 10-12% off the dollar. In the event, the Plaza "announcement effect"

was much more powerful than the G5 had expected. After barely a week with very small interventions, the dollar was down 12%, causing fears of an uncontrolled collapse.

There will be no Plaza Agreement this time. Wall Street interests have become absolutely predominant in Washington. In fact, both the U.S. economy and its financial markets have become so inordinately dependent on persistent, huge capital inflows that policymaking has no choice anymore. While a falling dollar would help the manufacturing sector, these beneficial effects would be vastly outweighed by the devastating effects that sharply slower capital inflows would do via a plunging currency to inflation, stock prices and long-term interest rates. Considering the potential sums involved, it could easily turn into Armageddon.

CONCLUSIONS:

Economic conditions around the world are worsening dramatically. In the past few years, large parts of the world economy became highly dependent on the bubble-related surge in U.S. import demand. The bursting of Japan's bubble was a problem for Japan; the bursting of the U.S. bubble is a global problem.

There is a striking dichotomy in the U.S. economy and the markets between great optimism talked and pessimism practiced. It's called confidence building. Mr. Greenspan, in particular, is engaged in the exercise to temper the slowdown by talking up the economy's long-term prospects. But when consumers and businesses are overextended, no amount of talk will prevent a painful reckoning.

An endless stream of very bad news from corporations themselves leaves no doubt that economic conditions continue to deteriorate. But in the public discussion, head-in-the-sand optimism prevails.

The greatest secret worry of all is that bad news about the U.S. economy may set off a free fall of the dollar. All it may need for that to happen is doubt in the dollar's stability inducing foreign holders of dollar assets to hedge the associated exchange risk. U.S. economic and financial prospects have effectively become hostage to the *perception* of an invulnerable dollar.

Considering the atrocious imbalances in the U.S. economy, the dollar's free fall is unavoidable.

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